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Minutes of Executive Board Meeting 92/115

10:40 a.m., September 11, 1992

R. D. Erb, Acting Chairman

Executive Directors

G. K. Arora

J. de Groote

D. Peretz

G. A. Posthumus

A. Torres

A. Végh

Alternate Executive Directors

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M. E. Hansen, Temporary

N. A. Espenilla, Jr., Temporary

J. Papadakis

A. F. Mohammed

A. Törnqvist, Temporary

N. Tabata

S. Shimizu, Temporary

B. Esdar

S. von Stenglin, Temporary

T. Sirivedhin

P. Rubianes, Temporary

I. Martel

H. Golriz, Temporary

L. J. Mwananshiku

J. Dorrington

B. A. Sarr, Temporary

A. G. Zoccali

L. Van Houtven, Secretary and Counsellor

S. J. Yeager, Assistant

1. Bolivia - 1992 Article IV Consultation, and Enhanced Structural Adjustment Facility - Additional Arrangement . . . Page 3
2. Zimbabwe - Requests for Enhanced Structural Adjustment Arrangement and Extended Arrangement . . . Page 26
3. Payments Restrictions for Security Reasons - Termination of Temporary Exemption from Performance Clauses . . . Page 48
4. Payments Restrictions for Security Reasons - Temporary Exemption from Performance Clauses . . . Page 48

5. Lithuania - Representative Rate for Russian Ruble
as Currency of Lithuania Page 48
6. Approval of Minutes Page 49
7. Executive Board Travel Page 49

Also Present

IBRD: D. de Tray, Latin America and the Caribbean Regional Office; F. King, Africa Regional Office. African Department: M. Touré, Counsellor and Director; E. A. Calamitsis, Deputy Director; A. I. Abdi, O. P. Brekk, P. Dhonte, K. B. Dillon, J. P. Gordon, H. Hino, A. Ibrahim, P. R. Wade. Legal Department: J. K. Oh. Policy Development and Review Department: T. Leddy, Deputy Director; A. R. Boote, M. E. Edo, T. Kosugi, J. Pujol, A. G. Santos, P. J. P. Szymzak, K. Thugge. Treasurer's Department: C. A. Hatch, S. T. Lurie. Western Hemisphere Department: J.-P. Amselle, P. D. Brenner, S. Clavijo, L. H. Duran-Downing, R. A. Elson, F. Fernandez, T. Gudac, C. E. Pinerua, J. Valdivia. Advisors to Executive Directors: M. Galán, J. Jamnik, J. M. Jones, R. Meron, B. Szombati. Assistants to Executive Directors: D. A. Barr, G. Bindley-Taylor, B. Bossone, M. Da Costa, Deng H., H. Dognin, B. Eggl, K. M. Heinonen, O. A. Himani, T.-M. Kudiwu, V. Kural, J. Mafararikwa, G. J. Matthews, D. Sparkes, N. Sulaiman, T. P. Thomas.

1. BOLIVIA - 1992 ARTICLE IV CONSULTATION, AND ENHANCED STRUCTURAL
ADJUSTMENT FACILITY - ADDITIONAL ARRANGEMENT

The Executive Directors considered the staff report for the 1992 Article IV consultation with Bolivia and Bolivia's request for an additional annual arrangement under the enhanced structural adjustment facility (ESAF) (EBS/92/137, 8/20/92). They also had before them a policy framework paper for 1992-95 (EBD/92/179, 8/19/92) and a statistical background paper (SM/92/169, 8/26/92).

Mr. Végh made the following statement:

As the staff report shows, Bolivia is a good example of a "successful adjuster" country and of the efficient implementation of an ESAF program. Bolivia is now entering the eighth year of macroeconomic adjustment and structural reform and has already exhibited favorable results, which are increasingly apparent.

The comprehensiveness of the staff report and the fact that the midterm review of the third annual arrangement was completed by the Executive Board barely three months ago (EBM/92/75, 6/12/92) provide some good reasons to be very brief in this opening statement. I will just emphasize some of the main results of the program during 1991 and the first half of 1992. In 1991, and for the first time in 15 years, the rate of growth of per capita output was significant, in the order of 2 percent. At the same time, the rate of inflation continued its declining trend and is now running at less than 1 percent per month. Sustained improvement in the balance of payments has been observed, despite important setbacks in the terms of trade; international reserves have increased and are reaching a comfortable level in terms of import requirements. A rescheduling agreement was reached in January 1992 with Paris Club members, and additional progress is to be expected, assuming good economic performance and compliance with Fund requirements. An initial understanding was reached with the main bank creditors in April 1992, and it is expected that the overdue debt to foreign commercial banks will be cleared in the near future.

During the first half of 1992, significant progress has also been made in the field of structural reform with the implementation of a broadly based privatization program. The state banks have been closed, except for one bank that has been excluded from conventional commercial banking activities. Regional development organizations are being streamlined and divested of most of their loss-making assets. Apart from the favorable effects from the point of view of economic efficiency in the productive sector, this privatization program will have a strong impact on the budgetary position in the future, which will supplement other

measures on expenditure control and revenue enhancement that are mentioned in the staff report.

The Bolivian authorities are requesting a fourth-year extension under the ESAF in order to complete the program. Their policy intentions and proposed measures for the next year and for the period 1992-95 are outlined in the Memorandum on Economic Financial Policies and in the policy framework paper of August 18, 1992. The latter includes, among other measures, further simplification of the tax system, progress in public enterprise reform, elimination of central bank losses, reform of the pension fund system toward a system based on individual capitalization, and improvements in energy policy.

In summary, Bolivia is close to a budgetary situation consistent with a further reduction of inflation to levels comparable to those of the large industrial nations. With continued support from the international financial community, evolution of the balance of payments indicates that viability is achievable in a few years. Private capital inflows are proceeding at a satisfactory level, although it is hoped that their composition will change gradually in the direction of direct and equity investment instead of debt and bank deposits. Domestic savings and investment are still at a low level, and the Government is aware of the necessity for improvement in order to accelerate the rate of growth in output and income. A recovery in agricultural exports is expected, and it is also hoped that this will coincide with a diversification of exports, including an increase in production and geographical dispersion of natural gas exports.

My authorities wish to express their gratitude to Fund management and the staff for their support during this period of intense adjustment.

Mr. Rubianes observed that during 1991, real GDP had grown by 4.1 percent, or by 2.1 percent in per capita terms, which was a significant increase for the first time since 1977. The 12-month rate of inflation had fallen to 14.5 percent in December, gross international reserves had increased to the equivalent of 4.6 months of imports, and private sector investment had increased sharply, as had public investment, even exceeding program targets.

In the first four months of 1992, it was estimated that real GDP had increased by 3.6 percent and that the rate of inflation had declined to 12.5 percent for the 12-month period ending in June, Mr. Rubianes continued. The value of gas exports would drop by 2.4 percentage points of GDP in 1992, with a net effect on fiscal revenue of about 1.7 percentage points of GDP, owing to deregulation of the energy sector in Argentina. Nevertheless, transitional compensatory financing had been established by Argentina.

The 1992-93 economic program envisaged real GDP growth of 3.5 percent a year, a reduction of inflation to 10.5 percent during 1992 and to 7.5 percent in 1993, and an increase in net international reserves equivalent to 5.5 months of merchandise imports at the end of 1993, Mr. Rubianes remarked. The deficit of the combined public sector would be limited to 3.7 percent of GDP in 1992 and to 3.2 percent in 1993. The structural reforms planned for 1992-95 aimed at improving the management of public sector operations, strengthening financial sector efficiency, and increasing domestic saving and investment in order to create a pattern of sustained economic growth.

He wished to reiterate his concern about the vulnerability of Bolivia's balance of payments prospects for the medium term, which required firm adherence to a tight monetary and fiscal program, as well as continued efforts on structural reforms, Mr. Rubianes commented. At the same time, he encouraged the financial community to maintain its financial support, and the Bolivian authorities to continue their efforts to minimize the growth of their external debt.

He also encouraged the authorities to complete the systemic adjustments, such as those concerning the operations of the Central Bank, tax reform, private investment incentives, and the divestiture of publicly owned enterprises and financial institutions, and to establish an adequate environment to improve the efficiency of public sector operations, Mr. Rubianes said.

He strongly endorsed the fourth annual arrangement under the ESAF for Bolivia, and agreed with the 1992-95 program, which built on previous achievements and the authorities' continued willingness to pursue prudent financial and monetary policy as well as plans to intensify structural reforms, Mr. Rubianes concluded.

Mr. Torres made the following statement:

As Mr. Végh very well points out in his buff statement, the comprehensive report presented by the staff, as well as the recent discussion of the Bolivian case in the Board, leave us very little excuse not to be very brief on this occasion. I would only add to Mr. Végh's reasons the strong perception that the Bolivian authorities have remained committed to the adjustment process, as it is expressed in the new policy framework paper and in the economic program for the additional annual arrangement. In light of these comments, I will only make a few remarks.

First, after several years of macroeconomic adjustment and structural reforms, the economy is showing signs of restoring its external and internal balance in a context favorable to achieving a sustainable growth path. The major signs of that success are expressed in the recovery of GDP growth, the deceleration of the inflation rate, the strengthening of the external sector, the improvement of debt ratios, and the recovery of public savings and

domestic investment. In order to consolidate those gains, it is necessary that the authorities continue their adjustment efforts and intensify the structural reforms aimed at addressing the major areas for concern that have already been discussed in previous Board meetings.

Second, in the fiscal front, we commend the authorities' efforts in 1992 to correct policy slippages and to compensate for the anticipated loss of revenues from gas exports. In that regard, the improvements in tax administration and the increase in the value-added tax, as well as the condition of current expenditure being below target allowed an increase in public sector savings larger than programmed for the first half of 1992. However, public investment outlays remained higher than envisaged. To maintain the target for the year as a whole, the authorities have decreased investments plans for the remaining of 1992. Other fiscal measures have been contemplated in order to reduce the combined fiscal deficit from 4.3 percent of GDP in 1991, to 3.7 percent in 1992. We commend the authorities' efforts, taking into account that the loss in revenue from gas exports amounts to about 1.7 percent of GDP. For 1993, further improvements in tax collection, adjustments in public tariffs, and expenditure controls, together with the impact of the privatization program, will allow an additional reduction in the deficit. In order to avoid the emergence of new slippages, particular attention should be paid to improving control over public sector investments. We welcome the steps already taken in that direction.

Third, the authorities have stressed the need to maintain sound monetary and credit policies to achieve the inflation and balance of payments targets. In this regard, we welcome the programmed reduction in central bank credit to the public sector in 1992 and 1993 which, as the staff points out, will ease the pressure on domestic interest rates, narrowing the spread between domestic and foreign interest rates, and discouraging the growth of U.S. dollar-denominated deposits.

Fourth, important steps have been taken in the area of structural reforms, and they have been very well presented by the staff. It is also clear that further efforts are needed as they have been envisaged in the program. We welcome the authorities' privatization plan, as well as the reforms contemplated for the financial system and public sector management. In particular, it is worth noting the sale of public enterprises scheduled to take place between 1992 and the first half of 1993, the initial steps taken to increase efficiency in the civil service, the project to privatize the administration of pension funds, and the increased transparency in the public sector accounts allowing the restructuring of the balance sheet of the Central Bank and the elimination of its losses at the beginning of 1993.

Finally, the staff projections for the external sector reflect a general improvement in many of the indicators, particularly gross reserves and debt ratios. Substantial external support has already been received from the international financial community. In addition, further steps will be taken by the authorities in order to normalize relations with commercial banks. While the medium-term outlook is now less discouraging, there is still much road to travel. Bolivia's economy remains highly vulnerable to external shocks and dependent on concessional financial aid. The authorities have made strong efforts to keep and to enhance the adjustment process, and their commitment deserves all the support that is needed in order to increase Bolivia's chances to achieve a sustainable growth path. We support the proposed decisions and wish the authorities all success in this new challenge.

Mr. de Groote made the following statement:

This is an interesting case of a country that, although particularly vulnerable to external shocks, has succeeded, with the aid of a three-year ESAF arrangement and continued assistance from creditors, in undergoing a process of fundamental economic change and rehabilitation. The recent increase in per capita income, the reduction of the inflation rate, economic diversification, and some strengthening of the balance of payments are welcome results of a program that was strongly supported not only by the Fund but by also by major concessions from creditors on the principal of their claims.

As a general remark, I very much agree with the staff's recommendation that although fiscal revenues have responded well to the new tax measures, it is crucial to enhance revenues by improving the tax system and tax collection. The magnitude of Bolivia's public deficit and the need for further expenditure make further revenue-enhancing and savings measures a real urgency. I therefore strongly agree with the staff that the authorities should be urged to restrain any increases in public sector wages and to protect the anti-inflationary growth targets by a better harmonization of fiscal and monetary policies in the medium term, since the effectiveness of monetary policy now appears to be under pressure from certain slippages in fiscal management and from capital movements.

To achieve such harmonization, the Ministry of Finance and the Central Bank need to establish a more effective coordination of policies. The mobilization of savings will also require that the pace of reform in the public and financial sectors not be relaxed. Privatization in particular should be accelerated. I especially welcome the authorities' intention to reform the

financial sector through legislation governing the operations of the Central Bank and the banking system, and also the ideas of transforming the remaining state bank into a small service agency and recapitalizing the Central Bank.

This brings me to a more specific question on the functioning of the financial market and exchange rate policy. A puzzling aspect of Bolivia's performance since the mid-1980s is the persistent increase of currency substitution in the financial system, which is shown clearly in Table 7 of the staff report. One can observe a sharp increase in M3 in real terms and as a share of GNP. The reduction in inflationary pressures somewhat reinforced the process of remonetization. But the reform also set in motion a portfolio diversification away from domestic money balances and toward foreign currency. As shown in Table 40 of the statistical annex, foreign exchange time deposits have grown rapidly.

Of course, this growth was not solely due to the reduction of domestic money assets, but an element of currency substitution is present. That this occurs despite shrinking inflation seems clearly to point to an ongoing process of dollarization rather than a one-time portfolio diversification. Moreover, statistics indicate that this shift is gaining strength over time. We therefore must ask the serious question whether a return to domestic currency assets is no longer more or less assured once the macro-economic situation stabilizes. There remains a fundamental anxiety on the part of holders of financial assets denominated in the national currency, which makes me wonder whether exchange rate policy may not be at issue here.

The idea that the real depreciation of the currency, which was obvious until 1991, represents a permanent trend could perhaps explain this situation. There was indeed a whole decade of real currency depreciation, which obviously fed anticipation and movement away to foreign currencies. This policy of constant depreciation has also had other important side effects, such as the constant depreciation of real wages, the maintenance of domestic real interest rates at levels much higher than foreign rates, and a constant increase in the real burden of public sector external debt. The question now is: what can be done?

Here again, we find we come back to the issue of public finances. There is probably no adequate answer to this situation other than a strong policy of fiscal retrenchment capable of inspiring confidence in asset holders and releasing Bolivia from a new round of self-defeating currency depreciations that are no longer justified, as they were in the past, by the balance of payments situation.

Mrs. Martel made the following statement:

Bolivia has achieved remarkable progress in the three years under the ESAF in reducing macroeconomic imbalances and introducing needed structural reforms, and I would like to join previous speakers in commending the Bolivian authorities for the results attained. Let me just highlight three major improvements: real GDP growth averaged 3 percent per year in the period 1988-91 and was 4 percent in 1991; the rate of inflation declined from 18 percent in 1990 to 14.5 percent in 1991 and now appears to be one of the lowest in Latin America; and important structural reforms have taken place, including the liberalization of products and factor markets, tax reforms, the recent enactment by Congress of the law on privatization, and the financial sector reform.

At this stage of the discussion, I would like to focus my comments on three issues--the prospects for attaining the inflation target, the outlook on the external front, and the performance of private saving and investment.

The projected decline in the combined public sector deficit, together with prudent monetary and credit policies, seems appropriate to meet the target of continued reduction in inflation. In this regard, reducing the deficit from 4.3 percent of GDP in 1991 to 3.7 percent in 1992 and 3.2 percent in 1993 seems well defined. Nevertheless, despite the measures taken on the revenue side and the planned cuts in expenditure, attaining the objective might prove difficult.

The recent experience shows past difficulties: in 1991, the deficit declined to 4.3 percent of GDP but exceeded the target of 3.2 percent, partly because of higher than programmed expenditure; for the first half of 1992, the limit for the deficit was not met, mainly because of higher than programmed public investment. Moreover, administrative bottlenecks reinforce the necessity to strengthen further the control over expenditure and to integrate the budget process with the fiscal program in the 1993 budget, which is a welcome structural performance criterion. In that connection, I understand that the public sector wage bill is to increase by 15 percent in 1992, compared with an average inflation rate of 12 percent, and to rise by 7.5 percent in 1993. This last figure results, in fact, from a nominal increase by 9.5 percent and a reduction in employment by 2 percent.

I share the staff's view that "it is essential that the authorities exercise restraint in granting increases in the public sector wages"--and I would add, especially in an electoral period--but fear the expectations and spillover effects on the private sector that the planned increases might create. I would appreciate some comments by the staff on this point.

On the external front, the situation is still worrisome. In 1991, the current account deficit widened to 6.2 percent of GDP, and in the first half of 1992, the current account was still weaker than expected. This reflects the deterioration of the terms of trade, the reduction in the price of natural gas exports, and weak metal prices. Also, despite the efforts made and the progress achieved in the debt situation, including the dropping of a large part of the bilateral debt to the United States and the rescheduling of debt-service obligations falling due through end-June 1993 under the December 1991 new menu of enhanced concessions, the debt burden is still elevated: the outstanding debt represents 70.5 percent of GDP and the debt service, 54 percent of exports of goods and services.

In this context, the medium-term projection appears to be very voluntarist. It assumes, notably, an increase in nontraditional exports and the pursuit of large debt relief, with two alternative scenarios leading to the elimination of external financing gaps by 1995 or 1997.

The credibility of the underlying economic policy rests on the pursuit of tight macroeconomic adjustment measures and prompt sectoral action to diversify the export base and to modernize the infrastructure, specifically in the area of transport and telecommunications.

A major obstacle still impeding the full restructuring of the economy lies in the insufficiency of private savings and the weakness of private investment. In fact, private sector savings declined from 2.6 percent of GDP in 1991 to 1.9 percent in 1992, far below the initial target of 3.3 percent of GDP. Private sector investment remains low, despite the recent pickup to 5.4 percent of GDP in 1992. Of course, I welcome the authorities' intention to modify the regulatory framework to encourage private sector participation in activities such as electricity, railways, telecommunications, and hydrocarbons. I understand that the Government is preparing the sale of those public entities that enjoy a public monopoly in the medium term. While considering the sequencing of these decisions to be appropriate, I would encourage the authorities to accelerate the whole process so as to foster private sector investment.

Globally, the adjustment measures taken by the authorities, and rightly so, will translate into a balanced development process under the condition of further increase of private savings and investment.

To conclude, I share the staff's opinion that financial policies, specifically fiscal policy, need to be monitored very closely, so as to achieve a low rate of inflation. I also think

that achieving the growth targets will require an increase in savings and continued financial assistance from creditors and donors for some years. I support the proposed decisions.

The staff representative from the Western Hemisphere Department said that the fiscal policy that was incorporated in the program contemplated a substantial adjustment if account was taken of the impact of the lower price of gas exports to Argentina. Overall, in the two years taken as a whole, there would be an adjustment of about 3.7 percentage points of GDP. To achieve that, it was essential, as mentioned by several Directors, that the authorities should continue to strengthen tax administration and to strengthen or maintain restraint in public sector wages.

The relation between public sector wages and private sector wages was tenuous in the case of Bolivia because there was no indexation mechanism to transmit the effect of increases immediately into the economy, the staff representative continued. The increases that were incorporated in the program took into account the fact that the Government was embarking on a program of civil service reform whereby it planned to restructure and rationalize the salary of the public administration, which was substantially low on average, and to take into account the advice and technical assistance that was being provided by the World Bank.

On the issue of monetary policy and the dollarization of the economy, one factor had contributed notably in recent years to increasing the dollarization of the economy, namely, in the past two years there had been some slippages in fiscal policy that had forced the Central Bank to conduct a tighter than programmed monetary policy, thereby increasing domestic interest rates beyond what had been foreseen, the staff representative explained. That had had the effect of inducing substantial amounts of capital inflows in the economy that had materialized in an increase in deposits with the banking system denominated in dollar terms.

The strategy of the program for 1992 and 1993 was aimed precisely at reversing that situation through a tightening of fiscal policy so that pressures on interest rates would be reduced, the differential between domestic interest rates and foreign interest rates would be narrowed, and the growth of short-term deposits with the banking system would decelerate, the staff representative from the Western Hemisphere Department remarked. The authorities expected that that process would result in at least a reduction in the rate at which dollarization was proceeding.

Mr. Al-Tuwaijri made the following statement:

The Bolivian authorities deserve strong commendation for the wide-ranging adjustment measures they have implemented over an eight-year period. As Mr. Végh has indicated, these measures have borne fruit as in 1991 growth reached its highest rate in

14 years, inflation declined to 14.5 percent, private sector investment increased markedly, and national savings rose substantially. In addition, the authorities implemented an ambitious structural reform program encompassing the tax regime, government financial operations, public enterprises, the financial and trade sectors, as well as domestic investment regulations. All these efforts constitute an impressive track record which, along with the proposed measures outlined in the Memorandum on Economic and Financial Policies, justifies the approval of an additional annual ESAF arrangement.

I broadly concur with the thrust of the staff appraisal. As the staff emphasizes, the authorities should maintain the momentum of structural adjustment in order to enhance the economy's ability to withstand exogenous shocks and to foster an environment conducive to robust and sustainable growth. In this context, the sharp reduction in the price of gas exports to Argentina will result in a sizable loss of fiscal revenue and foreign exchange earnings. Hence, I welcome the authorities' additional fiscal measures that promise to reduce the fiscal deficit in 1992/93 despite the reduction in revenue from the lower price of gas exports. Indeed, it is encouraging to note that such external shocks have not distracted the authorities from the need to persevere with the adjustment effort.

The recurrence of fiscal slippages in the first half of 1992 is worrisome. The authorities need to exert additional efforts to improve expenditure control and monitoring. Here, the proposed integration in the 1993 budget of the budget process with the fiscal program is highly warranted. Moreover, the intention of the Ministry of Finance to monitor, on a monthly basis, revenue and expenditure performance, along with its increased coordination with the Central Bank and the Ministry of Planning, should help improve expenditure control. In this regard, I share the staff's emphasis on the need to restrain public sector wage increases. Also, I particularly welcome the Government's attempts to increase the efficiency of the civil service by raising the remuneration for key positions, while containing the overall wage bill by eliminating redundant positions.

In many cases of successful adjustment, especially in Latin America, one observes a dramatic increase in capital inflows that complicates the conduct of monetary policy. The authorities are generally faced with the policy choice of either allowing the exchange rate to appreciate and thus risk a loss in competitiveness, or attempting to sterilize capital inflows, which would raise interest rates and further encourage capital inflows. In many cases, fiscal consolidation cannot occur at a sufficiently rapid pace to allow an overall reduction in interest rates and thus reduce capital inflows.

In the case of Bolivia, this difficult policy choice has not arisen. Indeed, owing to the pervasive dollarization of the economy, upward pressure on the exchange rates has not occurred, as the demand for bolivianos has not increased despite a period of sustained macroeconomic stability. Therefore, the inertial factors that have led to the persistence of dollarization are providing the needed breathing space for fiscal consolidation to induce a decline in interest rates and inflation prior to a remonetization of the economy. Hence, the authorities are correct in maintaining a flexible exchange rate and in pursuing sound economic policies that would gradually lead to an increased use of local currency deposits.

Mrs. Hansen made the following statement:

Overall, we agree with the staff's assessment that Bolivia continues to perform quite well. As Bolivia is one of the poorest countries in the hemisphere, it is particularly encouraging to note that 1991 saw a significant increase in GDP per capita, and that this occurred against the background of continued fiscal consolidation, declining inflation, and structural reform. Although a few areas need further attention, it appears that Bolivia's adjustment efforts over the last several years are yielding important gains.

On the fiscal side, we commend the Bolivian authorities for reacting promptly to the decline in export prices for its natural gas exports to Argentina with measures to shore up revenues and contain expenditures. We also recognize that the degree of fiscal adjustment programmed for this year is really much greater than meets the eye because of this revenue loss. Nevertheless, we are concerned about the recurring overexpenditure on the public investment program. This problem was noted at the Board's last discussion on Bolivia, and assurances were given at that time that the problem would be brought under control. Therefore, it would be helpful to have some further comment from the staff as to the prospects for bringing investment expenditure back on track in the second half, particularly as the strengthened monitoring procedures for expenditure control are not due to be in place until the end of 1992.

Closely related to the fiscal performance is Bolivia's structural adjustment program, especially its privatization program. We are pleased to see that the authorities are moving expeditiously toward completing the first round of large-scale privatizations and welcome the inclusion of a structural performance criterion on privatization in the fourth year program. Mr. Végh has suggested that substantial revenues are expected from privatization and the staff report notes that provision is made to

adjust the fiscal target for the privatization revenues that will go to the Central Government. I wonder whether the staff could give us an estimate of how much revenue the central authorities expect during the program period and how the revenues will be used. Is some consideration being given to putting these resources toward an eventual debt-reduction agreement with commercial banks?

In this connection, I wonder whether the staff has any further information on the sale of the national airline. We understand that on August 19, 1992 the authorities rejected the only bid they had received--from Iberia--because Iberia did not intend to inject the amount of new capital that the authorities had specified. Does the Government intend to continue putting its own resources into the financially troubled airline or is there still some prospect of privatization?

We are pleased to note that the 12-month rate of inflation had declined to 12-1/2 percent in June, notwithstanding a nearly 5 percent increase in the first few months of the year owing to energy price increases. We would be interested to know whether the staff has any more recent data to confirm this trend. Indeed, continued fiscal consolidation and the moderation of inflation should permit a further decline in interest rates, which are still high in real terms, and reduce speculative capital inflows.

As to the external sector, Bolivia's vulnerability to external shocks underscores the need for strong financial policies to help attract stable capital inflows and enable the authorities to absorb external shocks when they occur. It would obviously be helpful if Bolivia could develop other markets for its natural gas, although it would be some time before such investments could come on stream. In the meantime, I note that the bulk of the projected increase in the volume of exports is to come from nontraditional exports. Perhaps the staff could indicate which nontraditional exports show the most promise.

We also note that Bolivia continues to have a large debt burden, notwithstanding the efforts of the Paris Club and forgiveness of \$372 million in U.S. bilateral debt. In this connection, we are pleased to see that the Government has circulated a proposal to commercial banks, and we hope that negotiations will proceed expeditiously. At the same time, the expected need for future Paris Club reschedulings raises the question of what kind of Fund arrangement for Bolivia could provide the basis for further Paris Club action, following its fourth-year ESAF. Clearly, that is a decision that the Paris Club will have to arrive at when the time comes. However, in our view, continued strong policy performance offers the greatest assurance that the Paris Club will continue to give Bolivia favorable consideration.

In conclusion, we believe that Bolivia's strong adjustment efforts, coupled with the new shock of lower natural gas export earnings, justifies an exceptional fourth year under the ESAF, and we are pleased to support the proposed decisions.

Mr. von Stenglin said that he welcomed the substantial overall progress that Bolivia had made over recent years. Particularly remarkable were the increase in per capita income, the deepening of structural reforms in several areas, and the reduction in the stock of external debt.

The progress made toward external viability, however, was not sufficient to overcome the country's vulnerability to adverse external developments, Mr. von Stenglin observed. That was to a certain extent disappointing as Bolivia had continuously been supported by Fund resources since 1986. Moreover, following the expiration of the requested fourth-year ESAF, the country was expected to continue to depend on debt relief and concessional aid for some years, and--according to the staff--the Fund's financial assistance would be needed in the future. He was therefore concerned about the prospect of Bolivia's prolonged use of Fund resources with an uncertain outlook for graduation from exceptional external financing.

In view of the fact that Bolivia had successfully, although gradually, continued along the path of economic adjustment, and in view of the authorities' commitment to further adjustment both under the requested arrangement and in the medium term, he could support the additional annual arrangement under the ESAF, Mr. von Stenglin stated. He would, however, stress that a fourth-year arrangement required a strong performance and should not be seen as a regular prolongation of the Fund's financial involvement, but should only be granted in exceptional cases.

He broadly endorsed the staff's appraisal and had only a few remarks, Mr. von Stenglin continued. In view of the considerable growth of monetary aggregates envisaged for 1992, he drew only little comfort from the fact that the 12-month rate of inflation was so far in line with the unambitious objective for the year. He had some doubts whether the deceleration of inflation achieved so far could be sustained.

In the same context, he wondered whether a nominal exchange rate anchor would strengthen efforts to reduce further the inflation rate in that it would enhance the credibility of the anti-inflationary stance, Mr. von Stenglin commented. Moreover, that approach would be desirable in order to contain, if not reverse, the already high degree of dollarization of the economy, which in turn would strengthen the Central Bank's ability to control domestic liquidity.

He welcomed the recently approved tax code and hoped that the authorities would implement its provisions as soon as possible, Mr. von Stenglin remarked. In view of the country's low tax rate, he wondered about the

prospects for the Government to increase further its contribution to national savings by raising taxes beyond the provisions of the tax code. He would appreciate staff comment on that point.

He could support the proposed decisions, Mr. von Stenglin concluded.

Mr. Dorrington stated that he agreed with the thrust of the staff appraisal and with what had been said by other speakers. Successful completion of the three-year ESAF arrangement and the associated economic stabilization deserved commendation. A fourth-year arrangement was clearly warranted in view of the ongoing need for structural reform and the precariousness of the external outlook. But he also shared the concerns expressed, particularly on the need for fiscal restraint and improvements in public administration; the best intentions were of no value if they were not realized. He wished to highlight a few selected points.

Despite considerable progress, there was still a long way to go toward medium-term viability, Mr. Dorrington observed. It was essential to maintain the momentum of adjustment through the presidential elections in 1993 and beyond. To that end, efforts should be focused on maintaining and enhancing the prospects for foreign direct investment. Continued progress by the authorities would need to be matched by generous concessional treatment by creditors.

It was surprising to see that private sector savings continued to fall despite a significant rise in real deposit rates, Mr. Dorrington commented. The structural reforms of the banking sector therefore took on particular importance. It was essential that they not be delayed further. Plans to introduce competition into pension fund management were also clearly welcome. He would, however, caution on the need to ensure adequate safeguards.

He wished to add a general point on privatization, Mr. Dorrington continued. He was convinced that competition was at least as important as ownership, and he hoped that in Bolivia, when public sector monopolies were privatized, every opportunity was taken to introduce competitive markets.

Inflation was one area where progress had been slower than expected, Mr. Dorrington observed. Interpreting monetary aggregates was complicated by the magnitude of capital flows, but the easing of domestic monetary conditions as a response to continued capital inflows gave him serious cause for concern. He noted in that connection that the recent Research Department paper on capital inflows and real exchange rate appreciation in Latin America (WP/92/62, August 1992) gave a valuable discussion of the policy options. In view of Bolivia's vulnerability to commodity prices and other external shocks, it was particularly important to make good progress on inflation while such shocks were absent.

He supported the intention to reduce the flexibility in exchange rate management, Mr. Dorrington said. Greater nominal stability would provide a

helpful policy anchor to reduce inflationary expectations. He would appreciate staff comment on the scope for further appreciation of the boliviano in view of the 4 percent rise over the past 18 months.

He had read with interest the latest Research Department paper on currency substitution in Bolivia (WP/92/65, August 1992), although it was intrinsically difficult to capture the important expectational influences in econometric models, Mr. Dorrington commented. He would appreciate staff comment on the extent to which harm was done by dollarization. If domestic policies were sound, how significant was the domestic damage? The paper referred to relatively low inflation rates, which was certainly true compared with 1985, but inflationary expectations remained significant, and there remained a perceived risk of a return to much higher rates. Inspiring confidence in the medium-term stability of the currency was at least as important as achieving reductions in the current rate of inflation, although he did not belittle the importance of that.

He supported the proposed decisions, Mr. Dorrington remarked.

Mrs. Sirivedhin made the following statement:

I am much encouraged by Bolivia's adjustment efforts. With GDP growth averaging about 3 percent during 1988-91, savings doubling to 6.5 percent, and the external position improving markedly, the underlying economic conditions appear to be conducive for further improvement in the economy.

Meanwhile, the authorities unfortunately have to face adverse terms of trade and widespread poverty. The vulnerability of the economy to adverse external developments requires strong domestic policy efforts toward stabilizing output, reducing inflation further, enhancing market forces to promote efficiency, and alleviating poverty. These issues are addressed in the authorities' program for 1992-95, and since I am in general agreement with the thrust of the staff's appraisal, I will make only a few brief comments.

The task of maintaining GDP growth of 3.5 percent during the period 1992-95, the lowering of the inflation rate from 14.5 percent in 1991 to 5 percent by 1995, and maintaining that level in an environment of unstable prices for Bolivia's exports is challenging. I would think that the bulk of the increase in economic activity has to be generated in the private sector. The growth target would be attainable only if the assumed financing is available and if the legal framework and regulatory conditions are simplified to make the economy conducive to productive investment. In this context, it is equally important that the implementation of the privatization program be accelerated.

I note that current gross fixed investment, which is at a level consistent with availability of domestic savings and net private transfers from abroad, is still low. This underscores the need to design a foreign investment policy that would encourage the inflow of external savings. I welcome measures to promote foreign investment in the hydrocarbon sector, although emphasis should also be given to promoting investments in the nontraditional sectors of the economy where employment creation is most likely.

The shift in emphasis to public investment for infrastructure and the social sector, although a welcome development, will require sufficient public savings. In this connection, the fiscal deficit has to be reduced further. This is not an easy task, since the revenue base remains fragile despite some significant and far-reaching tax reform. Under the circumstances, it is crucial that expenditure restraint be adhered to in addition to improvement in tax administration.

I concur with the staff regarding restraint on public sector wage increases. The prevention of slippages in the fiscal area will also make it easier for the authorities to continue to adhere to the prescribed monetary and credit policy.

Vigilance in controlling the development of liquidity conditions is essential to ensure the maintenance of positive interest rates in order to promote domestic financial savings and stability in the foreign exchange market.

The viability of the balance of payments and the prospects of the external sector largely depend on the debt profile and the development of the export sector, which in many ways are influenced by the external situation. The staff paper raises my concern about the sensitivity of the external position, which would imply a faster domestic adjustment and a tight domestic financial policy than is currently foreseen. Therefore, I believe that it is most appropriate that the program be reviewed whenever there are wide fluctuations in external prices. More important for the medium term, the authorities would have to use every means possible to diversify both its exports and market destinations in order to better shield the economy from adverse external developments.

In view of the determination shown by the authorities under the current ESAF arrangement and Bolivia's financing needs, I support the request for an additional annual arrangement. The Fund's continued support is important in sustaining the policy measures needed to augment the performance of the Bolivian economy in the medium term. With these observations, I support the proposed decisions.

Mr. Posthumus said that he supported the proposed decision on Bolivia's stabilization and adjustment program. He had two questions, one regarding speculative capital inflows, which had already been posed by Mr. de Groote and answered by the staff; the other concerned the motivation underlying the request for a fourth-year ESAF arrangement. The staff report indicated that the arrangement was needed to adjust to the adverse effects of the reduction in the price of natural gas exports to Argentina. That had, of course, been a big shock to the economy, but he doubted that it was completely unexpected. He therefore questioned whether that was a strong argument for a fourth-year arrangement. He suspected that such an arrangement was a prerequisite for Paris Club rescheduling. If so, and if another rescheduling was needed in the coming year, he wondered what would then be the prerequisite for gaining Paris Club support. That aside, he supported the proposed decisions.

Mr. Tabata said that the authorities were to be commended for having restrained inflation in the past few of years. However, the inflation rate was still in the double digits. It was expected that the program target of a single-digit price increase in 1993 would be attained.

In order to attain that target, it appeared necessary to continue the cautious monetary stance in 1992 and 1993, Mr. Tabata observed. The authorities, however, intended to relax monetary conditions. The projected increase in M3 of 20 percent in 1992 and 15 percent in 1993 seemed to be somewhat on the high side, taking into account the targeted growth and inflation rates.

In addition, the authorities intended to lower interest rates through market operations in order to reduce capital inflows, Mr. Tabata commented. The orthodox approach was to maintain the domestic interest rate at a certain level so as to restrain inflation and at the same time to continue sterilizing the inflows of capital. He would appreciate the staff's comments on that point.

Regarding the medium-term growth strategy, export volume was projected to increase by 10 percent in 1993 and to continue to be almost 6 percent during the period 1994-97, Mr. Tabata observed. As the staff stated, gas exports to Argentina would not increase substantially because of the decline in prices. He wondered whether the staff could indicate which industries were expected to be leaders in keeping exports buoyant in the coming years.

Prudent policy implementation was crucial in order to attain medium-term sustainable growth and external viability, Mr. Tabata remarked. He hoped that the authorities would execute their policies with caution. With those comments, he supported the proposed decisions.

Mr. Noonan said that his chair concurred generally with the staff's appraisal, supported the proposed decisions, and shared with others the concern that fiscal policy should adhere to program; therefore, he would not

repeat what earlier speakers had already said. He would, however, like to make one comment and ask one question.

He noted from footnote 2 on page 6 that the proceeds of the sale of public enterprises would be earmarked for public investment in the social sectors and infrastructure in the regions where the enterprises were located, Mr. Noonan remarked. Social and infrastructural investments incurred current expenditures; for example, building a public hospital always seemed to incur public expenditure in running that hospital. He therefore urged caution as regards the extent to which social and infrastructural investments were undertaken to ensure that the facilities provided were consistent with the financial and other capacities to run and maintain them. Otherwise, that apparently progressive step would not prove to be as progressive as it might seem on first sight.

In his opening statement, Mr. Végh had drawn attention to the desirability of more foreign direct investment in Bolivia, Mr. Noonan recalled. Like Mrs. Martel, he had noted that private sector investment, while it had grown to almost 5.5 percent of GDP, was still relatively small, especially when compared to the small size of Bolivia's per capita GDP. Apart from improving the regulatory environment, to which both Mrs. Martel and Mrs. Sirivedhin had referred, he wondered whether the staff considered that other actions were open to the authorities that could improve the attractiveness of Bolivia as a location for the commercial investments needed to underpin more rapid and sustainable growth.

The staff representative from the Western Hemisphere Department observed that the policy dilemma suggested by the strong growth of monetary aggregates and a declining inflation rate was not unique to Bolivia but was characteristic of a situation where the scope of monetary policy was severely limited because of private capital inflows and the openness of the economy. In that context, fiscal policy was playing a preponderant role in controlling inflation and maintaining competitiveness. Bolivia's program had been cast in that light. In 1990 and 1991, slippages in fiscal policy, combined with the Central Bank placing a considerable amount of paper in the market, had raised interest rates substantially, thereby inducing capital inflows. The program was aimed at reversing that situation and producing a domestic fiscal surplus so that the Central Bank could contract substantially domestic assets and achieve the objectives of reducing interest rates and inflation, as well as the convergence of domestic interest rates with relevant foreign interest rates. The relation between inflation and monetary aggregates should be viewed in that light. In particular, a distinction had to be made between the Central Bank's actions and what was happening in the rest of the economy. In fact, the increase in monetary aggregates was not being induced by the Central Bank and there was no easing in monetary policy. Rather, it was expected that under the program, there would be a sharp contraction in the net domestic asset position of the Central Bank in both 1992 and 1993 and that the rate of currency growth would be consistent with the reduction in the inflation rate. In that context, the monetary aggregates broadly reflected a series of

demand-determined private sector transactions that did not necessarily result in an acceleration of inflation.

As to the projection of exports in the medium-term scenario, the expected sharp pickup in 1993 was related to the fact that in 1992, a number of factors, and in particular, floods in the main agricultural areas, had resulted in a substantial drop in the agricultural production and exports, the staff representative explained. The projections reflected a rebound from that depressed situation. Beyond 1993, the increase in exports was broadly based on substantially increased investment in the mining and hydrocarbon sectors, which was also reflected in the projection of private investment, in addition to the growth of exports in the agricultural sector and light manufactures. In the agricultural sector, soya--one of the main products--was growing especially rapidly.

The regulations pertaining to the implementation of the tax code had been effected, and revenues continued to show the strong performance that had been evident in the first half of the year, the staff representative remarked.

As to the behavior of investment in the first half of the year and the deviations from the program, in September the authorities had started to implement monitoring procedures to take into account the recurrent problem of coordination between public enterprises and the Central Government and within the Central Government between the Ministry of Finance and the Ministry of Planning, which was in charge of implementing the program, the staff representative commented. Thus, procedures had already started to be put in place and were expected to result in more control on investment.

Although there had been some delays in the privatization of the state-owned airline, the authorities were continuing their efforts to privatize the enterprise, the staff representative continued. The Minister of Planning had indicated that one alternative that was being explored as part of the privatization process was the issuance and sale of airline shares in the stock market.

As to how to encourage private investment, most of the legal framework providing the basis for the development of private investment and foreign investment had been approved under the second-year ESAF arrangement, the staff representative from the Western Hemisphere Department stated. In particular, major laws had been passed concerning direct investment, including the revised mining code, which was viewed by private investors as a major field of investment, and the hydrocarbon law, which allowed the state petroleum company to enter into joint ventures with private capital. Thus, the legal framework was in place, and the authorities believed that private investment had picked up substantially during 1991 and would continue to pick up in 1992, as was reflected in the staff's medium-term scenario.

The staff representative from the Policy Development and Review Department recalled that questions had been raised concerning the rationale for the fourth-year ESAF and its relation to Bolivia's negotiations with the Paris Club. In the case of Bolivia, recent developments had been somewhat different from what had been expected earlier. There had always been some uncertainty concerning trade relations between Bolivia and Argentina in connection with hydrocarbon and gas exports; in fact, problems in this area had existed throughout the period of the ESAF and had not been fully settled in a manner satisfactory to both parties. However, the assumptions made throughout the program period about this issue had allowed the authorities to implement a substantial economic adjustment program with some favorable results. The recent trade agreement, however, had resulted in significant gaps in Bolivia's financial situation, thereby creating a magnitude of balance of payments need that represented a new, complicating factor affecting the course of the authorities' program and that in itself would have been sufficient to warrant the consideration of a fourth-year ESAF.

The Fund had always encouraged the orderly settlement and restoration of normal relations between creditors and debtors, and in that context, it had collaborated closely with the Paris Club and other creditors to facilitate that process, the staff representative remarked. The minutes of the recent Paris Club meeting on Bolivia referred specifically to the desire of the Paris Club creditors that Bolivia should continue to have an appropriate arrangement with the Fund, so that creditor countries could consider further debt- and debt-service refinancing or restructuring for Bolivia in the future. That consideration also had some weight in proposing a fourth-year ESAF.

Bolivia's financing requirements would have to be revisited in the future, in the context of developments in its overall balance of payments, its policies and efforts to solve its underlying problems, and the general policies of the Fund vis-à-vis the use of its resources under various facilities, the staff representative from the Policy Development and Review Department stated. On the whole, however, there had been a significant improvement in the Bolivian economy, and although the country faced difficulties in the future, as shown in the staff's medium-term analysis, there was some light at the end of the tunnel. In the circumstances, the Fund would want to find ways to assist Bolivia in solving those difficulties.

Mr. Végh said that he was grateful to Executive Directors for their support and wished to assure them that he would faithfully convey their observations and suggestions to his Bolivian authorities.

He wished to endorse the staff's views on the privatization of the national airline, Mr. Végh remarked. In fact, he would extend that suggestion to many other state-owned monopolies throughout the world and especially in Europe in light of the danger that they would extend their monopoly positions by buying Latin American state-owned monopolies.

On the issue of currency substitution and its connection with monetary policy and exchange rate policy, Mr. Dorrington had mentioned recent research papers on exchange rate appreciation, capital inflows, and the efficiency of sterilization, Mr. Végh recalled. In the paper prepared by the Fiscal Affairs Department and the Western Hemisphere Department on the recent experience of Bolivia with currency substitution, the staff stated that "many developing countries have been subject to extensive currency substitution with foreign money substituting for domestic money in all its functions as a store of value, as a unit of account, as a medium of exchange," which represented "a market-induced monetary reform on the demand side." That view was similar to his own, as expressed in the context of some other country cases, that currency reform was effected by the public because of the absence of a good reliable domestic currency and because of fiscal indiscipline. In examining models of currency substitution, it was important to distinguish between two different kinds of differentiation--the differentiation that always played a role in the models between the domestic currency and domestic deposits denominated in foreign currency and the differentiation between the rate of interest on domestic deposits denominated in foreign currencies, as in the case of Bolivia.

The question concerning whether the Bolivian preference for foreign currency--the U.S. dollar--and the fact that it had not diminished in spite of low inflation and increased confidence in government management and the domestic currency could be mainly explained by a long process of depreciation of the domestic currency, was a good one and had not been addressed in staff papers, Mr. Végh observed. His own tentative answer, pending more careful analysis in the context of several countries, would be negative. In fact, Uruguay, for instance, provided a counterexample in the sense that in spite of the continuing appreciation of the domestic currency, which had been going on for several years, there had been no significant reduction in the dollarization of the economy.

Moreover, unlike the staff, he considered that dollarization was good and that it did not do any significant damage to the economy, Mr. Végh stated. In his view, there was nothing intrinsically advantageous for small countries--or even large countries--in having their own currencies. In addition to the fact that dollarization was effected by the public and was therefore sort of a market-induced phenomenon, it was also good for inflation performance. The higher the dollarization of an economy, the less incentive a government had for an inflation tax, because it operated on an extremely small tax base.

The Acting Chairman made the following summing up:

Executive Directors were in broad agreement with the staff appraisal. They noted that the authorities' efforts to strengthen macroeconomic policies and implement structural reforms in recent years had resulted in the resumption of growth in real GDP per capita, lower inflation, and significant progress toward external viability.

Directors observed, however, that Bolivia's economy remained vulnerable to external developments. This was evidenced just recently by the adverse effect of the sharp reduction in the price of gas exports to Argentina, which will result in a sizable loss of foreign exchange earnings and fiscal revenue in 1992-93. Directors welcomed, in this connection, the actions taken by the authorities to deal with the repercussions of the loss in gas export earnings. To consolidate progress toward sustained growth, Directors urged the authorities to intensify their efforts to improve economic efficiency by implementing structural reforms and strengthening the public finances, and to continue the pursuit of policies aimed at reducing inflation further and fostering private savings and investment as well as export diversification. Directors commented favorably on the authorities' program for 1992-93, which was geared to the achievement of these objectives in the framework of a medium-term strategy.

Directors were in general agreement with the authorities' fiscal objective for 1992-93, but noted with concern the fiscal slippages in the first half of 1992. Thus, they urged the authorities to proceed without delay with the measures envisaged in the program to improve fiscal policy coordination, to strengthen expenditure control, and to enhance tax administration. Also, they stressed the importance of exercising restraint in public sector wage policy and of moving ahead with the civil service reform. Improved monitoring to avoid overruns in public investment outlays was also needed.

Directors drew attention to the effects of the continued large short-term private capital inflows, which were complicating monetary and exchange rate management and contributing to a high degree of dollarization. However, with a tighter fiscal stance in the rest of 1992 and in 1993, the pressure on domestic interest rates might ease somewhat, thereby reducing incentives for private short-term capital inflows. In addition, Directors noted with concern the low levels of private sector savings and investment.

In their comments on the foreign exchange system based on central bank auctions, speakers generally took the view that the system had aided Bolivia in adapting to large external shocks and considered it advisable to retain the flexibility of the system. Nevertheless, they emphasized the importance of pursuing policies, particularly tighter fiscal policies, that would assure the continued reduction of inflation and that would safeguard Bolivia's international competitiveness and protect the balance of payments. Some Directors, however, recommended consideration of smaller movements in the nominal exchange rate in order to improve the prospects for inflation.

Directors underscored the importance of the authorities adhering to their program of structural reform, including the sale or liquidation of public enterprises and the recapitalization of the Central Bank. They also underscored the importance of prompt congressional approval of the central bank law and the banking system law in order to help improve confidence in the domestic financial system.

Even with the strong planned adjustment program being carried out, Bolivia's medium-term outlook continued to show the need for substantial external financing and debt relief on highly concessional terms for the years ahead, both from the commercial banks as well as from official creditors. It was stressed that future concessional external assistance would require the maintenance of strong economic policies and continued structural reform.

It is expected that the next Article IV consultation with Bolivia will be held on the standard 12-month cycle.

The Executive Board took the following decisions:

Exchange Measures Subject to Article VIII

1. The Fund takes this decision relating to Bolivia's exchange measures subject to Article VIII, Section 2(a), in the light of the 1992 Article IV consultation with Bolivia conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. Bolivia maintains an exchange restriction evidenced by some external payments arrears to commercial banks that is subject to approval under Article VIII, Section 2(a). In view of Bolivia's intention to eliminate its external arrears by the end of the year, the Fund grants approval for the retention by Bolivia of the exchange restriction evidenced by these arrears until end-December 1992.

Decision No. 10126-(92/115), adopted
September 11, 1992

Enhanced Structural Adjustment Facility - Additional Arrangement

1. The Government of Bolivia has requested an additional arrangement under the enhanced structural adjustment facility.

2. The Fund has appraised the progress of Bolivia in implementing economic policy and in achieving the objectives

under the program supported by the third annual arrangement and has noted the updated policy framework paper (EBD/92/179).

3. The Fund approves the arrangement set forth in EBS/92/137, Supplement 2.

Decision No. 10127-(92/115), adopted
September 11, 1992

2. ZIMBABWE - REQUESTS FOR ENHANCED STRUCTURAL ADJUSTMENT ARRANGEMENT
AND EXTENDED ARRANGEMENT

The Executive Directors considered the staff report on Zimbabwe's request for arrangements under the enhanced structural adjustment facility (ESAF) and for an arrangement under the extended Fund facility (EFF) (EBS/92/141, 8/27/92; and Cor. 1, 9/10/92). They also had before them a policy framework paper for the period 1992-95 (EBD/92/153, 7/20/92) and the following statement by the Acting Managing Director:

There follows for the information of Executive Directors the text of a memorandum that I have received from the World Bank to serve as the basis for my statement on the matter to the Board. This text summarizes the main points covered by the Committee of the Whole of the Executive Directors of the Bank and the International Development Association in their meeting on August 4, 1992.

The Committee of the Whole welcomed this first policy framework paper for Zimbabwe as a further demonstration of Zimbabwe's commitment to continue reform, in spite of complications caused by the drought that has devastated southern Africa. The objectives were supported, and the timing was thought to be realistic. Executive Directors expressed particular appreciation for several aspects, including:

1. The fact that Zimbabwe is pressing forward with structural adjustment in very difficult circumstances. The drought has caused unfortunate increases in both the central government deficit and the current account deficit, but Zimbabwe is continuing with structural reforms. In this regard, the continued liberalization of trade was noted by several Directors.

2. Efforts being made by Zimbabwe to shield poor and vulnerable groups from the effects of the drought and any adverse transitional effects of structural adjustment. It was widely acknowledged that the Government had to spend money on these programs to minimize adverse social consequences.

3. Initiatives to generate rapid recovery from the drought. In particular, the provision of inputs of seed, fertilizer, and chemicals to all small-scale farmers and the higher producer price for staple foods were seen as important. It was emphasized that the introduction of new technology into agriculture should be free of restrictions such as tariffs and import controls.

4. Efforts to protect social services, particularly education and health, from expenditure cuts, as much as possible.

The key concerns expressed by Executive Directors were:

a. That the Land Acquisition Act be implemented in a fair and transparent manner that maintains agricultural production and general business confidence.

b. That the targets and the means of achieving them were not sufficiently detailed in the policy framework paper, particularly in the discussion of sectoral issues. Directors noted that the upcoming progress review before releasing the second tranche of the structural adjustment loan would be important and welcomed the move to advance the consultative group meeting to December.

c. The apparent slow progress with civil service reform. Reductions in the civil service wage bill in the 1992/93 budget were appreciated, but the limited progress in reducing the size of the civil service to date does not generate confidence that the timetable for reducing the civil service will be achieved.

d. The rather slow pace of structural reform to increase the efficiency of public sector enterprises. This reform was felt to be a key to efforts to reduce the budgetary deficit.

e. The achievability of export growth of 10 percent per annum and the GDP growth rates of 7 percent in 1993 and 6 percent in 1994 and 1995.

f. The need for longer-term social programs to be financed from the Government's own resources, to avoid these programs becoming dependent on donor finance.

g. The lack of sectoral detail in the medium-term plan for reducing the fiscal deficit. Directors accepted the fact that drought-related expenditure will push up the deficit temporarily, but noted the importance of public expenditure control to promote long-term macroeconomic stability, protect social services, and prevent crowding out of private investment.

h. The likely effects of such tight monetary policy on business recovery and investment, though it was acknowledged that

there seems to be no alternative to this tight monetary policy for now.

Mr. Mwananshiku made the following statement:

My Zimbabwean authorities are in broad agreement with the staff appraisal and welcome the comprehensive coverage of the papers. They also wish to thank Fund management and staff for their helpful advice and support in the negotiations leading to the request for arrangements under the enhanced structural adjustment facility and the extended Fund facility at a critical moment in the history of the country.

Against a background of large domestic and external imbalances, Zimbabwe in January 1991 launched its own comprehensive medium-term program in the Framework for Economic Reform 1991-95. The objective of that program was the enhancement of external competitiveness and productivity. However, in January 1992, that program was transformed into a Fund-supported medium-term framework aimed at fundamental structural reforms of the economy over the period January 1992-January 1995.

Unfortunately, since the program was approved by the Board, the Zimbabwean economy has been devastated by the worst drought in the history of southern Africa, leading to a drastic fall in production and worsening the balance of payments situation, the fiscal position, and the rate of inflation.

The production of the major agricultural crops--including the staple crop, maize--is now estimated to fall by about 75 percent. As a consequence, Zimbabwe, normally a food surplus country, has suffered a large supply shortage that calls for imports of major food items, and some manufacturing inputs such as cotton. Zimbabwe will also import electric power. Moreover, the country continues to lose substantial agricultural, mining, and industrial exports owing to water shortages and constant power interruptions.

Despite the severity of the drought, my Zimbabwean authorities pressed ahead with the implementation of the reform program. They have been able to hold the 1991-92 fiscal deficit at 9.1 percent of GDP, a level some 1.7 percent of GDP lower than in the previous year, in spite of the substantial drought-related expenditures. The authorities also continued with the reform of the civil service and since July 1991 have eliminated 6,941 established positions from the civil service, ahead of schedule.

The program also provided for a restrictive monetary policy aimed at moderating inflation, especially in view of the negative impact of the drought on supply. Accordingly, the monetary policy

stance was tightened in the first quarter of 1992 and interest rates were significantly raised. However, in the second quarter monetary developments proved to be somewhat accommodating, reflecting, principally, the effects of the drought.

Progress was also made in the reform of public enterprises. The majority of them have now been accorded the necessary degree of autonomy in the fixing of prices and the hiring and firing of labor. As a result of these reforms, substantial price adjustments have been made, and these have contributed to the improvement in the financial position of some public enterprises.

A new labor act was passed early this year to allow more flexible retrenchment procedures with a view to improving the investment environment. In addition, the authorities are expected to enact soon legislation granting legal status to the Zimbabwe Investment Center, which will help to streamline the procedures relating to the approval of new investments.

In the area of price liberalization, the progress made was ahead of schedule. By April 1992, 75 percent of local products were free of price control, compared with the original target of 66 percent by end-December 1992. At the same time, the number of products under direct government price control, consisting mainly of essential consumer items, was reduced from eight to five, and further progress is expected.

The liberalization of imports also proceeded as scheduled. The Open General Import Licence system and the Export Retention Scheme were both expanded to allow greater access to imports. In addition, the negative list for the Export Retention Scheme has been reduced.

In view of the new situation created by the drought, my authorities have made modifications to the program that was approved by the Board last January. Accordingly, they have requested an extension of six months, to June 1995, in order to allow time to achieve the original program objectives. The modified program now before the Board is the result of these changes. Its aim is to contain the domestic and external imbalances created by the drought while at the same time accelerating the implementation of structural reform.

In the fiscal area, the authorities aim at keeping the deficit at about the same level as in 1991-92, despite the drought-related expenditures of 6 percent of GDP and a decline in revenue equivalent to 6.5 percent of GDP. This will be achieved by postponing nonessential capital and recurrent expenditure and reducing military expenditure. In addition, civil service retrenchment will be accelerated and wage increases will be

contained at only 15 percent, substantially lower than the current rate of inflation. Similarly, subsidies and net lending to public enterprises will be reduced. The effect of all these measures, coupled with increased external grants and loans, will be to eliminate all net domestic borrowing from the banking system.

The aim of monetary policy is to restrain inflationary pressures by holding down the growth of reserve money. This will be achieved through a number of policy initiatives. Interest rates will be kept positive in real terms. Already, rediscount rates have been raised by 5 percentage points. Reserve requirements have also been doubled to 12.5 percent. In order to facilitate policy implementation and achieve an improvement in the conduct of monetary policy, the staff of the Reserve Bank are to receive further training. Moreover, the compilation of monetary statistics will be improved, and the use of indirect monetary policy instruments will be expanded.

In their external policies, the authorities will seek a gradual improvement in the level of the Reserve Bank's international reserves while maintaining a competitive external position. In this respect, the promotion of traditional and nontraditional exports will continue, and the exchange rate policy will be used flexibly. The use of export incentives will be accelerated, and the Export Retention Scheme will be further expanded. Furthermore, the authorities will seek to mobilize additional external resources in the form of grants and concessional loans.

Despite the pressures created by the drought, my authorities intend to further accelerate structural reform, building on the progress already made. As regards state enterprises, the aim is to fully eliminate the operating losses of most of them by the end of 1992/93. To achieve this, state enterprises will continue to raise tariffs, improve efficiency, and reduce labor costs through retrenchment.

Under the modified program, the authorities will also continue the policy of price deregulation as additional products are added to the Open General Import Licence or where domestic competition is judged adequate. By June 1993, 85 percent of domestic production will be free of price control. In the case of the five items still under the direct control of the Government, prices were raised substantially in the period January-August 1992.

My authorities attach great importance to the early recovery of the agricultural sector. Accordingly, in the Agricultural Policy Statement of February 1992 covering the 1992-93 marketing year, agricultural prices and marketing were liberalized. This policy was further strengthened in July when agricultural

marketing boards were given the necessary pricing autonomy. As a result of these changes, producer prices are now negotiated freely above the guaranteed floor prices, which themselves are at the export parity level for most products. At the same time, the authorities intend to implement the new land legislation flexibly, taking into account the best interests of the agricultural sector and the nation as a whole.

In conclusion, may I reiterate the fact that Zimbabwe is facing a critical situation as a result of the most severe drought the country has ever faced. It requires both economic and humanitarian assistance from the international community if Zimbabwe is to survive the crisis.

Mr. Peretz made the following statement:

The effect on Zimbabwe of the drought in southern Africa has been much more serious than the Board expected when it approved the extended arrangement in January. The authorities deserve a good deal of praise for keeping the program broadly on track in these difficult circumstances, and for not allowing crisis management to deflect them from their broader medium-term strategy. This is a good sign for the future. But the additional assistance that the authorities have received in the wake of the drought will, at most, provide a temporary breathing space. The effects of the drought will continue to be felt for several years to come. I was pleased to see that, even so, the authorities have committed themselves to bringing the program back in line with its original objectives by 1994. They are also determined, quite rightly, to avoid a rescheduling of their commercial or official debt, and to limit strictly any increase in short-term nonconcessional debt.

I welcome this first ESAF program for a newly ESAF-eligible country. I also welcome the way in which the Fund is proposing to help sustain the momentum of Zimbabwe's adjustment program. In my view, front-loaded and augmented ESAF access blended with an extended facility is in this case justified by the conditionality, and is the most appropriate way for the Fund to respond to what should prove to be a temporary but large external shock. The additional resources that the Fund is committing have been more than matched by the World Bank and individual donors.

Fiscal consolidation remains the key element of the program. It will require a continuous effort throughout the program to achieve a sustainable budget deficit. Even when account is taken of drought-related outlays, public spending in Zimbabwe is too high. The authorities need to take a critical look at which categories of spending contribute significantly to economic development and which do not. The authorities should, in

particular, be looking to reduce spending on the civil service, the military, public enterprises, and untargeted consumer subsidies, which are a costly and inefficient means of social protection. I am therefore glad to see that the program tackles all these areas and commits the authorities to cutting nondrought spending by almost 10 percent of GDP over the coming year. This is quite an achievement.

On monetary policy, I welcome the authorities' decision to follow a policy of positive real interest rates. The staff appraisal correctly identifies the dilemmas of monetary policy. But the sooner inflation is reduced and the faster the Central Bank acts to establish its clear commitment to this objective, the sooner interest rates can be reduced. The exchange rate can only be used as an anchor against inflation if it is supported by sufficiently strong policies. Above all, this will require sticking to a firm and clear monetary stance. Nevertheless, I agree that it will be sensible to review exchange rate policy as part of the first program review.

Trade liberalization is another area where the authorities need to be seen to be acting quickly if trading partners and potential investors are to be convinced that Zimbabwe is a desirable place to do business. Without this, the ambitious export growth projections will not be met. I welcome the plans to keep expanding the Open General Import License system and extending the Export Retention Scheme. The paper states that 70 percent of imports will pass through these liberalized channels by mid-1993. I would urge even faster progress--and I would in any event be interested to know the main categories that will still be subject to restrictions after mid-1993.

I agree with the authorities' priorities for structural reform. Here, we should also take note of the comments of World Bank Directors on the policy framework paper, circulated with the Managing Director's statement of August 17, 1992. Good progress has been made in some areas, but I am concerned that there still seems to be no medium-term strategy to address the financial difficulties of some of the largest parastatal companies. It is also worth bearing in mind that pricing autonomy in itself is no guarantee of increased public enterprise efficiency. This also requires genuine competition. Experience everywhere else suggests that the best way to achieve this is by a process of deregulation and privatization--bringing benefits of lower prices, greater efficiency, and, ultimately, higher output and employment.

As the policy framework paper makes clear, the agricultural sector will play a key role in Zimbabwe's future development. It is essential that farmers face proper price signals, and the drought has added particular urgency to this. Remaining price

controls and subsidies should be eliminated as quickly as possible. The supply response could be significant. Finally, I would stress the importance of applying the recent land legislation in a way that does not damage agricultural production or investor confidence. In this context, I welcome the indications in the Memorandum of Economic Policies that land acquisition will be limited to unutilized land, and that the legislation will be implemented in a way that does not harm investment and growth. With these remarks, I can support the draft decisions.

Mr. Sarr made the following statement:

It is clear from the staff report and from Mr. Mwananshiku's helpful statement that the Zimbabwean authorities had to undertake a major reorientation of their economic policies during the first six months of this year in order to mitigate the overwhelming impact of the drought. The implementation of the emergency drought relief program over that period had a major impact on the authorities' balance of payments, fiscal, and inflation objectives. Nevertheless, they were able to strengthen policies in key areas with some positive results as evidenced by the easing of inflationary pressures noticed in July 1992 and the improved functioning of the trade sector. Given the fundamental structural policies already in place and the reversible nature of the drought-related deviations from the program, I fully support the authorities' request for arrangements under the extended Fund and enhanced structural adjustment facilities. I also find appropriate the proposed front-loaded phasing, which takes into account the strength of the corrective measures already implemented under the program and the larger than expected financing gaps. I have only a few observations, for emphasis, on the macroeconomic aspects of the program.

With regard to the fiscal sector, despite the accommodating fiscal stance in 1991/92 and the prospect for higher fiscal deficit in 1992/93, the underlying fiscal position has been strengthened markedly thanks to the fiscal structural measures put in place over the recent years and those envisaged under the present program, particularly the civil service reform and large cuts in expenditure categories such as subsidies, net lending to public entities, and military spending. However, the weak financial position of the public enterprise sector is likely to continue to pose a serious challenge to the authorities' medium-term fiscal adjustment effort. In this regard and given the projected decline in revenue in 1992/93, the authorities will need to consider as soon as feasible a broadening of the range of policy measures needed to ensure that these enterprises will contribute positively to the fiscal effort over the medium term and facilitate the much-needed reduction in the tax burden.

With regard to monetary policy, the exceptional financing needs resulting from drought-related imports and trade liberalization have undoubtedly introduced some uncertainties into the conduct of monetary policy in Zimbabwe. This seems to have manifested itself in the softening of the money market and in the disruption in some business activities that have not yet fully adapted to the new liberalized environment.

During this transitory stage, the staff and the authorities will need to monitor closely developments in the financial sector in order to avoid the stop-and-go credit policy experienced so far during the first half of this year. In this regard, I welcome the authorities' intention to strengthen their analytical capacity and improve coordination between monetary and fiscal policy. Perhaps the staff or Mr. Mwananshiku could update our information on the ongoing efforts to improve monetary policy coordination.

Zimbabwe's external payment position is projected to remain difficult, with a large but declining financing gap projected over the next two years and a somewhat deteriorating debt-service ratio during the same period. However with the expected impact of the incentive package and the trade liberalization currently measures under way, as well as the authorities' intention to improve the management of their external debt, the medium-term external position could strengthen substantially by 1995. The forthcoming program review, shortly after the consultative group meeting, should provide a good opportunity for the staff and the authorities to assess further Zimbabwe's long-term balance of payments prospects. In this regard, we look forward to the in-depth analysis of trade reform measures to be conducted during the midterm review.

Mr. de Groote remarked that the Zimbabwean authorities were to be congratulated for having succeeded in maintaining the stance of reform in spite of most adverse climatic circumstances. He particularly welcomed the fact that the country had maintained its debt service and that the different debt ratios had continued to improve in spite of those circumstances.

Given that favorable performance, he was pleased to support the proposal for a three-year arrangement under the ESAF and for a new three-year extended arrangement, and he wished to congratulate the staff for the imagination and initiative developed in order to propose that combined solution to the Board, which also had the advantage of including some front-loading, a feature that was very much needed under current circumstances, Mr. de Groote stated. It was indeed a good example of the flexibility the Fund was capable of for countries that perform well and that had developed credible policies.

The implementation of that program depended on progress in four major key areas--fiscal adjustment, monetary tightening, extension of price and trade liberalization, and completion of public enterprise reform, Mr. de Groote continued. The fiscal adjustment expected in 1992/93 was certainly a major one--9 percent of GDP--and included curtailment in the wage bill, military expenditure, and subsidies for public enterprise. Difficult as they might be, those efforts were needed, and the Fund should clearly continue to explain to the authorities that there was no way to avoid that effort. Indeed, apart from those items, difficulties could loom in the area of public enterprises--for example, the Ayrdine steel company--that represent risks for the whole program. Early actions were therefore needed, and it was very much hoped that there would not be any slippage in the implementation of those objectives.

Over the medium term, further substantial reduction of expenditures was needed to curb the still excessive ratio of public expenditure to GDP and to create capacity for reducing in general the tax burden on the economy, Mr. de Groote commented. The wage bill, combined with accelerated civil service retrenchment, would be a good candidate for further streamlining.

On the monetary area, there was no alternative but to pursue tight policy in the coming several months, Mr. de Groote considered. He therefore especially welcomed the large increase in the discount rate--5 percent--and the increase in the reserve requirements. The need for improving monetary procedures and for strengthening supervisory mechanisms would justify stronger technical assistance by the Fund in those areas.

On price deregulation, it was true that there was some progress but in a phased way, and perhaps in an excessively slow way, Mr. de Groote remarked. Price deregulation should be accompanied by the breaking up of domestic monopolies to ensure genuine competition. Similarly, more rapid progress with liberalization of trade and the foreign exchange allocation system would improve the access to inputs and capital goods which were fundamental to export growth.

On public enterprise reform, which was critical for the program, what was envisaged would clearly have positive effects on the fiscal adjustment and on the efficiency of competitiveness, Mr. de Groote observed. But steps so far had been concentrated on improving financial performance and increasing price autonomy. Privatization has not much to do in all that. It seemed to be missing altogether from the authorities' consideration in most cases, and it was not mentioned by Mr. Mwananshiku.

Although the economy was still at the initial stage of deregulation, increasing private sector participation would help to accelerate the process, Mr. de Groote stated.

Mrs. Martel made the following statement:

At the outset, I would like to commend the authorities of Zimbabwe for having taken early actions during the second quarter of 1992 to mitigate both the social and financial impact of the severe drought that has devastated food crops in southern Africa. Thanks to prudent budget management and large external assistance, Zimbabwe has indeed been able to secure a sufficient drought relief effort to shield the most vulnerable segments of the population, while maintaining macroeconomic adjustment broadly on track.

Even more important for the future are the early steps taken to ensure the availability of inputs of seeds and fertilizer for the next crop season, as well as the decision not to slow down the pace of structural reform, particularly in the area of import liberalization.

All these decisions, under very difficult circumstances, reinforce the credibility of the authorities' three-year program. Furthermore, as the program is designed to achieve most of the macroeconomic targets of the original arrangement by 1994, despite the impact of the drought, I would broadly endorse the program described in the staff report and would only emphasize two areas of the policy mix that deserve particular attention, namely, inflation and structural reform, before making some remarks on the financing of the program.

I certainly agree with the staff that demand-tightening measures are critical to the program's success, and I was impressed by the comprehensive set of measures adopted in the 1992/93 budget not only to meet the overall objective of narrowing the deficit but also to restructure expenditures and broaden the tax base. On the expenditure side, I particularly welcome the projected reduction of nondrought expenditures by 9 percent of GDP, with cuts being achieved most notably in the wage bill, subsidies, and military expenditures, while the relative share of priority expenditures, including health and education, is being increased.

Nevertheless, for several years growing inflation and uneven monetary control have clearly been an underlying weakness of the adjustment program in Zimbabwe and have contributed to an increased misallocation of resources and a rapid decline in domestic savings, as interest rates remained negative in real terms. Moreover, as evidenced by monetary developments in 1991/92, inflation, net of the drought effect, continued to increase, reaching an annual rate of 25 percent in June. Despite significant repayments by the Government to the banking sector,

inflationary pressures have been fueled by a softening of credit policy and reserve requirements.

To achieve the intended investment-led recovery of the economy over the medium term while reducing external financial imbalances, the authorities should devote the utmost attention to bringing inflation back under control as rapidly as possible. In this respect, it is critical that interest rates be brought to, and maintained at, positive levels in real terms. I noted with satisfaction that benchmarks have been set in the program regarding interest rate levels, but I would appreciate confirmation by the staff that interest rates are positive in real terms as of September. I also concur with the staff that central bank monitoring of money growth will have to be strengthened so as to keep close control of the monetary aggregates, particularly during a period of highly variable levels of output and revenue owing to the drought. It is therefore all the more important that the Government be prepared to make sufficient repayments to the banking sector so as to accommodate credit demand from the private sector.

To conclude on this point, it is worth noting that, under the current exchange regime, a rapid reduction in inflation will contribute to enhancing overall external competitiveness of the economy.

On structural reforms, I would like to join other speakers in commending the authorities for the significant headway they have made in liberalizing the economy and for the clear timetable to further decontrol prices and trade that has been set up within the guidelines of the program.

Agriculture will be a key factor for an early recovery of the economy as well as to reduce the hardships of the population. I therefore can support the authorities' package of agricultural policies. However, as soon as market conditions allow, I encourage the authorities to phase out controls in the maize sector and extend pricing autonomy to the Grain Marketing Board while opening the maize market up to private traders so as to eliminate the significant burden that subsidies to this sector put on the budget.

Concerning public enterprise reform, the Government has undertaken bold steps to increase prices so as to eliminate operating losses incurred by the major enterprises. This demonstrates the Government's commitment to implement the progressive restructuring of the public sector, as announced in the initial program. In this regard, I particularly welcome the support provided by the World Bank to restructure the Post and Telecommunications Corporation and the electricity company. For

the other major companies, such as the steel company and Air Zimbabwe, where pricing and managerial autonomy will not be sufficient to restore financial viability, the authorities should seriously consider private participation to avoid costly financial support over the medium term from the Government.

The drought compounded the effect of the liberalization of imports by seriously widening the current account deficit to 19.2 percent of GDP in 1991/92. Nevertheless, barring unforeseen adverse developments, a return to the original path of adjustment with a deficit, excluding official transfers, brought down to 6 percent of GDP by 1994 is achievable, if the demand-tightening and inflation-reducing measures are implemented as planned. I particularly welcome the fact that large concessional assistance will cover the financial impact of the drought.

Considering the strength of the program and the difficult circumstances, the staff proposes a large increase in access and a front-loading under both the ESAF and the extended arrangement. Two points are worth noting. First, the access for the newly eligible members was supposed to be, according to our guidelines, around 80 percent of quota on average. Second, under the guidelines, the use of ESAF Trust resources could be blended with resources from the General Resources Account, taking into account some factors such as per capita income and debt-servicing capacity.

In the case of Zimbabwe, I found it puzzling that none of these factors were put forward in the staff paper and that the increase in access under the ESAF arrangement resulted in a level of access--105 percent of quota--well above the average agreed upon in February. While I find this exceptional for a newly eligible country, it is my understanding that the decision is taken in due consideration of the drought in Zimbabwe and that such a deviation from our guidelines will not be repeated in the absence of such exceptional circumstances.

The staff representative from the African Department recalled that Mr. Peretz had noted that imports free of licensing restrictions were expected to rise to 70 percent by June 1993 and had asked which imports accounted for the remaining 30 percent. The remainder consisted of three main elements: petroleum, which was to be imported exclusively by the public enterprise, accounted for 12 percentage points; imports for projects funded directly by bilateral government agencies accounted for 10-15 percentage points; and the remaining 10-15 percentage points were accounted for by imports on the negative list under the Export Retention Scheme, including textiles.

The authorities had been sending central bank staff to central banks in industrial countries for training with a view to strengthening the implementation of monetary policy, the staff representative commented. They had also strengthened monetary statistics. For example, previously, data on broad money was received with a lag of six to eight weeks, which hindered the authorities' ability to react quickly to developments. Under the new system, commercial banks reported data for the past two weeks as well as their expectations with respect to the coming two weeks. In a sense, the authorities could thus monitor the money supply on a continuous basis. That was but one example of the efforts that were being undertaken to strengthen monitoring.

On interest rates, the staff representative from the African Department stated that the interest rate on 91-day certificates of deposit was about 40 percent in nominal terms and that the inflation rate in July and August had been 1.6 percent, which was high because of increases in the maize price and in excise duties on petroleum products. In view of the expected rate of inflation, the staff considered an interest rate of 40 percent to be positive in real terms.

Mr. Al-Tuwaijri made the following statement:

I welcome this discussion of Zimbabwe's request for arrangements under the enhanced structural adjustment and extended Fund facilities. This unique combination of facilities will provide the needed support for the Government's ongoing efforts to minimize the severe negative effects of the drought and to restore the role of the market mechanism in the economy. Clearly, the challenges facing the authorities are enormous, as the drought has resulted in the loss of about three fourths of the maize, sugar, and other summer crops and has undermined the country's macro-economic performance during the first half of 1992. Moreover, this new crisis emerged at a time when the Government was striving to adjust to extremely large macroeconomic imbalances brought about by years of large fiscal deficits, negative real interest rates, and the rapid expansion of domestic credit. Hence, the Government's prompt response to the crisis and its continued commitment to pursue the reform program are commendable and deserve the support of this Board.

I am in general agreement with the staff appraisal and recommendations. However, I would like to emphasize the following points.

The authorities' ability to keep the structural reforms on course, despite strong pressure to scale them back, is praiseworthy. However, the slow progress in restructuring the public enterprise sector raises some concern. While the steps taken so far, including the granting of pricing autonomy to a number of public enterprises, are in the right direction, a more rigorous

approach will be needed to reduce public expenditures and to ensure an efficient allocation of resources. Hence, I am in full agreement with the staff's recommendation in this area.

The drought and its associated expenditures have exerted great strains on the central government budget, resulting in a deficit equivalent to 9.1 percent of GDP. The proposed program envisages a commendable reduction in nondrought expenditure, including cuts in the wage bill, subsidies, and lending to public enterprises. Notwithstanding these strong efforts, strict control of nondrought spending, in line with the budgetary provisions, cannot be overemphasized. This should help bring down inflation to the targeted level, which in turn should help ensure an investment-led economic recovery. The authorities have set themselves commendable, albeit ambitious, targets, which require the full implementation of the proposed program. In addition, it is gratifying to see that Zimbabwe is current in all its international financial obligations despite its extremely difficult circumstances. With these remarks, I support the proposed decisions.

Mr. Tornqvist remarked that the authorities were to be commended for their efforts to follow the program agreed with the Fund as closely as possible, in spite of the serious impact of the drought on the economy of Zimbabwe. The authorities had handled that unforeseeable difficulty in a commendable way. The reform program had been kept largely on track. In fact, progress was ahead of schedule in some areas, and that performance had to be regarded as impressive. He especially welcomed the results achieved in public enterprise reform.

Macroeconomic adjustment had certainly been set back by the drought, but that was understandable, Mr. Tornqvist commented. Taking the impact of the drought into account, there had also been progress in that area.

Looking ahead, the proposed program seemed ambitious under the prevailing difficult circumstances, which would continue to affect the economy for some time, Mr. Tornqvist continued. If the goals were to be achieved, macroeconomic policies would have to be adjusted quickly and decisively. In that context, his chair shared the concern expressed by other speakers regarding the slippage in monetary policy in excess of what could have been expected owing to the drought. He agreed with Mr. de Groote and the staff that there was no alternative to a tight monetary policy if inflation was to be reduced from the current high level. As a minimum, positive real interest rates had to be restored soon. He welcomed the intentions expressed by Mr. Mwananshiku in that respect.

In his authorities' view, Zimbabwe needed and deserved the support of the international community in its current difficult circumstances, Mr. Tornqvist stated. They considered the proposed modified program

sufficiently strong to justify the requested arrangements. His chair could support the proposed decisions.

Mr. Shimizu made the following statement:

The drought in southern Africa has complicated the authorities' adjustment efforts by making the macroeconomic imbalances worse. Under the circumstances, it is commendable that the authorities are sticking to the objectives of the adjustment program, thus minimizing the damage caused by the drought. I welcome the fact that the authorities have revised their medium-term economic program to take into account the impact of the drought and are requesting an ESAF arrangement. In light of the limited access to ESAF resources and the large financing requirement, the proposed blend of ESAF and EFF resources is highly appropriate. Since I am in broad agreement with the staff appraisal, I will only emphasize a few points.

The fiscal program for 1992/93, especially on the expenditure side, is ambitious. It is envisaged that nondrought expenditure will be reduced by almost 10 percent of GDP. In particular, I welcome the fact that most of the reduction in expenditure comes from cuts in unproductive expenditures, such as subsidies and military spending. On the revenue side, while I understand the need to reduce the burden of income tax, I believe that the need to strengthen the revenue structure in the medium term should not be neglected. From this viewpoint, an expansion of the tax base through the adoption of a value-added tax might be considered. I would be interested in hearing from the staff whether the authorities have any plans in this regard.

Although I welcome the recent move to tighten monetary policy, it seems far from sufficient. The rate of inflation is still high, and Chart 2 shows an increasing trend of monetary aggregates and rate of inflation. A further tightening of monetary policy is therefore warranted. As to interest rate policy, it is regrettable that the authorities failed to maintain positive real rates. I would urge the authorities to keep interest rates positive in real terms.

On the structural front, in order to make Zimbabwe's economy vigorous and efficient, it is necessary to increase the scope of private sector activity by reducing the size of the public sector. From this standpoint, I welcome the recent reduction in the size of the civil service. But since the authorities do not have a medium-term strategy in this regard, I would urge them to set up a timetable for reduction of the civil service. I would also urge them to formulate a privatization program.

I understand the rationale for using the exchange rate as a nominal anchor, but I have some doubts about the sustainability of this policy. Because of the high rate of inflation, the real exchange rate has appreciated, and I am concerned about adverse effects on external competitiveness. In addition, since the level of foreign reserves is low, I wonder whether the authorities will be able to maintain the exchange rate for a long time. Finally, in view of the real appreciation of the official rate, a parallel market should have emerged. I am afraid that the existence of two exchange rates will distort the efficient allocation of resources. I would be interested to hear the staff's comments on this point.

In conclusion, the authorities' efforts to reduce the macro-economic imbalances under difficult circumstances have been commendable, and the program seems ambitious enough to achieve the authorities' medium-term objectives. Moreover, it is highly commendable that the authorities do not intend to request a rescheduling of the external debt. Their commitment deserves the support of the international financial community. With these comments, I support the proposed decision.

Mrs. Krosby made the following statement:

Just after launching a tough program under an extended arrangement early this year, Zimbabwe was hit severely by drought. The program's original goals of simultaneously stabilizing and liberalizing the economy have been seriously tested by the harsh effects of the drought in the first half of the year, which have brought about sinking real GDP, accelerating inflation, and expanding fiscal and current account deficits. Against this background, the Zimbabwean authorities' desire to push ahead, first, by continuing reform efforts as planned in areas not affected by drought, and second, by reinforcing financial efforts stronger than in the EFF program with the intention of returning to the original program path quickly, is rather impressive. The steps taken so far constitute a promising commitment to this program and, if pursued to the end, Zimbabwe will set an excellent standard for other economies in the region.

The fiscal program laid out in the 1992/93 budget is strong, with substantial expenditure reduction planned despite lower revenues caused by both the drought as well as ongoing long-term tax reform. The August increase in maize prices, given its budgetary as well as domestic sensitivity implications, was an important indicator of the seriousness of the authorities' commitment to structural and economic reform. Similarly, the sizable cuts taken in the past year, beyond those programmed, in civil service employment levels, stands out at a time when declining production is depressing employment prospects elsewhere in the

economy. We note that a significant amount--about 4 percentage points of GDP--of the planned expenditure cuts comes from postponing nonessential expenditures. This could cause a buildup of pressures for additional spending in the next budget and complicate deficit reduction efforts in coming years. As to financing the budget deficit, we were pleased with the targeted reduction of net domestic financing to close to zero this year, including a net repayment to the domestic banking system.

Zimbabwe has been liberalizing prices at a faster pace than originally programmed, with 75 percent of production now free of controls. However, that level still indicates that there is some distance to go, and we look forward to further price increases in commodities--including maize--airfares, and electricity tariffs, among other prices, as the program unfolds. With regard to investment practices, in the hope that the current slow investment demand is reversed, we urge the quick adoption of the Investment Act aimed at improving investment procedures.

There are three areas of particular concern and interest for future reviews: monetary policy, trade liberalization, and public enterprise reform. Starting with the last, we observe that progress on restructuring public enterprises has been slow, even though more responsible financial practices with more realistic pricing are now usually the rule. Price decontrol that allows covering current costs is an important step forward, but public enterprises' accumulated debt could still be a steady drain on the budget. A solution to debt problems needs to be found, in view of their contribution to the slippage in last year's fiscal budget. Also, we would like to see more substance given to the authorities' intentions to privatize public enterprises, and we therefore hope to see much more concrete detail in future reviews.

While there has already been a degree of trade liberalization, there is still a long way to go, with only 40 percent of imports free from restrictions and only 25 percent of export earnings allowed for imports as of this summer. We fully support the inclusion of further trade action as a performance criterion in the current program and would encourage the authorities to move even more quickly, as possible, to simplify and liberalize the trade regime.

The flip-flop on monetary policy in recent months is cause for concern. Action seems to have been taken too quickly, too frequently, and too dramatically--all of which points clearly to the need to hone policy tools. As an adequately developed government paper market seems to exist, it would seem that more use could be made of it rather than frequent resort to the reserve requirement. We are pleased that central bank authorities are getting assistance in indirect market-type monetary policy

options. The problem is not academic, as containment of money and credit expansion is essential to bringing inflation under control. The inflation rate, net of drought effects, may seem to be closer to the original target in recent months, but the lower rate will need to be sustained and improved. The establishment in July of positive real discount rates should be continued, and we note very affirmatively the authorities' intention to continue this policy, which has wisely been included as a specific program benchmark.

One final point regarding the external policy regime: in view of the importance of export growth--particularly of nontraditional exports--for a narrowing of the current account deficit as well as an improvement in economic prospects, it will be essential to maintain competitiveness by bringing inflation down and under control through firm financial policies, as well as by keeping a close eye on the exchange rate level through frequent reviews.

The level of access requested under the proposed mix of ESAF and EFF resources suggests that a very strong program must decisively be in place. We are convinced that this is the case. The Fund has shown flexibility in adapting the program in the face of the drought, and the Zimbabwean authorities have shown their corresponding responsibility by moving broadly on a comprehensive, sustainable reform package without losing sight, despite the short-term crisis, of long-term goals.

Mr. Esdar said that it was commendable that the authorities had succeeded in sustaining the adjustment efforts despite the extreme difficult climatic circumstances, as underlined by the fact that more than one half of the impact of the drought had been offset by a tightening of domestic policies. He could therefore fully support the proposed decisions.

While he was in broad agreement with the staff appraisal, he wished to make a few observations, Mr. Esdar continued. The first half of 1992 showed a somewhat mixed picture of overperformance in some areas like price liberalization and external trade reform, and delays in implementation in other areas, particularly in the reform of the public enterprises. He wished to echo other speakers in their recommendations to avoid any further delays in those crucial areas and to speed up the restructuring of public enterprises. He noted that the schedule for civil service retrenchment had been accelerated and that in the past year the reduction of civil service positions had exceeded the original target. However, the World Bank Board, when discussing the policy framework paper, was somewhat more skeptical regarding those results and objectives. He would appreciate staff comment on whether an additional reduction in the civil service was feasible or desirable.

He shared the view that the acceleration of inflation was the most worrisome development in Zimbabwe, Mr. Esdar remarked. Part of the increasing price pressures was drought-related, and it could be expected that those developments would be reversed. However, in the first half of 1992, the underlying inflation rate had exceeded the program target, and the description of monetary developments offered a somewhat confusing picture. According to the staff paper, monetary conditions had been tightened in early 1992 to offset early excessive liquidity creation. In March, reserve requirements had been reduced "in response to the tighter money market conditions." Thus, requirements were doubled at the end of June "in response to the softening of the money market conditions." He was somewhat concerned about that stop-and-go approach, and he believed that a more predictable course of monetary policy would be highly advisable, particularly to avoid severe disruptions in the money markets and business activity.

In that regard, he welcomed the authorities' intentions to follow a policy of positive real interest rates, Mr. Esdar commented. He noted, however, that the definition of real interest rates was restricted to interest rates on three-month certificates of deposit. Usually, it was expected that all interest rates, regardless of maturity, should be positive to give the right signals. He wondered whether that implied that other maturities or assets did not play any significant role in Zimbabwe, and that the development of interest rates other than those on three-month certificates of deposit could be neglected.

As to the proposed access, Zimbabwe was one of the first of the newly eligible countries requesting an ESAF arrangement, Mr. Esdar stated. At the time of the extension of the list of eligible countries, a consensus had been reached that access should on average be limited to 80 percent of quota. Among the factors that would determine the access in each individual case, such as the countries' balance of payments needs and the strength of the program, particular reference was also to be made to the country's need for concessional assistance as reflected by per capita GNP or indebtedness. While access of 105 percent under the ESAF might be justified in view of the impact of the drought and the balance of payments, it was somewhat surprising that there was no reference to those indicators in the staff paper. For future requests, he would expect to see the Board's view in that regard reflected more adequately in the staff papers.

Mr. Golriz said that the authorities' commendable response to the impact of the severe drought had resulted in a macroeconomic outcome in the first half of 1992 that was broadly in line with the program. The prompt and timely response of the World Bank in providing loans for economic reforms had also contributed to that outcome.

The government deficit had been reduced by 1.7 percent of GDP, compared with the previous years, and government net payments to the domestic banking system had totaled 1.2 percent of GDP, compared with projected borrowing of 1.8 percent of GDP, Mr. Golriz observed. Inflation was estimated to remain

at about 20 percent, with the direct impact of the drought accounting for 10 percentage points. Those were, not surprisingly, the consequences of a combination of tight fiscal and monetary policies. However, the promising medium-term outlook illustrated in Chart 3 and Table 6 of the staff report would be realized only if the authorities continued to deepen their restructuring efforts. He noted that those efforts had continued as a main task of the Government. The rehabilitation of public enterprises, price deregulation, civil service retrenchment, and the liberalization of the trade and exchange rate system had been addressed despite the adversities owing to the drought. He encouraged the authorities to maintain the pace of the reform, although, at the same time, efforts should be made to protect the vulnerable segments of society that needed the Government's protection during the transition period. A transparent safety net targeted toward the most hard-hit groups would secure the support of the populace for the reforms.

On external policies, he endorsed the recent liberalization effort and commended the authorities for their excellent debt-servicing record, Mr. Golriz remarked. At the same time, he believed that maintaining a stable exchange rate as an anchor against inflation was understandable in the short run. However, in order to secure external competitiveness, the exchange rates might need to be monitored constantly and adjusted as circumstances permitted. With those remarks, he supported the proposed decisions.

Mr. Papadakis made the following statement:

I am in broad agreement with the staff's analysis, and I support the proposed decisions. There have been positive aspects in policy implementation so far, which have to be judged against the serious effects of the drought. Overall budgetary management has been prudent; the losses of public enterprises have been reduced; trade liberalization continues; price decontrol has accelerated; and foodstuff prices were promptly adjusted in response to supply shortages. There have been some difficult decisions to take in the face of the devastating effects of the drought, and the authorities have displayed realism and the courage to take them.

In the proposed program, the key element is the reduction of the central government deficit in 1992/93. The envisaged reduction in nondrought-related expenditure by 9.5 percent of GDP represents a strong but indispensable adjustment. Its realization presupposes strong and successful efforts to contain the wage bill, subsidies, and lending to public enterprises. The recent reduction in the number of ministries will do little in achieving civil service retrenchment unless prompt action is taken to eliminate redundant posts. Moreover, lending to public enterprises will be difficult to contain, without their expeditious restructuring, the vigorous strengthening of their financial

positions, and the privatization of their ownership. In sum, financial retrenchment will depend heavily on the pace of structural reforms.

On the revenue side, in view of the sharp drought-induced revenue losses, I am not sure of the appropriateness of the timing chosen to move in line with the long-term objective of reducing the admittedly high tax burden.

With respect to monetary policy, I concur with the view that, under the circumstances, there can be no alternative to a tight stance in the period ahead to control inflation and contain import demand. This only adds to the need to achieve sizable reductions in public sector imbalances so as to avoid overextending the period of high interest rates and credit squeeze to the private sector.

Domestic financial policies are the key to establishing external viability, which also depends heavily on the response of exports. Looking to the medium-term scenario, I wonder to what extent the projected 11.5 percent average annual growth of export volume is achievable through domestic adjustment policies alone. The authorities' decision to treat the exchange rate as an anchor against inflation has so far been a wise policy. But can this policy be sustained even with the program fully on track? It would be risky to attempt a definite answer at this point without a clearer indication of how long it would take for the economy's export potential to substantially recover from the drought-driven shock. At any rate, the projected growth rates for exports and GDP further emphasize the crucial role of the private sector in stimulating investment, improving the efficiency of resource allocation, and increasing productivity and competitiveness.

In concluding, I wish to reiterate this chair's sympathy to the authorities of Zimbabwe for the extremely difficult economic circumstances they face as a result of the unprecedented drought. We greatly appreciate their efforts and resolve to address the situation in the best way possible, namely, by following a pragmatic approach, which reflects unequivocal commitment to medium-term macroeconomic adjustment and structural reform.

The Executive Directors agreed to continue their discussion in the afternoon.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/92/114 (9/9/92) and EBM/92/115 (9/11/92).

3. PAYMENTS RESTRICTIONS FOR SECURITY REASONS - TERMINATION OF TEMPORARY EXEMPTION FROM PERFORMANCE CLAUSES

The exemption from performance clauses under Fund arrangements set out in Decision No. 9598-(90/166), adopted November 26, 1990, relating to restrictions and arrears on payments and transfers to persons within the territory of Kuwait is terminated. (SM/92/174, 9/3/92)

Decision No. 10128-(92/115), adopted
September 9, 1992

4. PAYMENTS RESTRICTIONS FOR SECURITY REASONS - TEMPORARY EXEMPTION FROM PERFORMANCE CLAUSES

1. Notwithstanding performance clauses pertaining to the imposition or intensification of restrictions on payments and transfers for current international transactions, and to external payments arrears, in stand-by, extended, or enhanced structural adjustment arrangements, and until further notice by the Fund, disbursements under such arrangements shall not be suspended because of restrictions and arrears on payments and transfers to the Government of the Federal Republic of Yugoslavia (Serbia and Montenegro) or persons within its territories.

2. This decision shall apply to disbursements made on or after May 30, 1992. (SM/92/175, 9/3/92)

Decision No. 10129-(92/115), adopted
September 9, 1992

5. LITHUANIA - REPRESENTATIVE RATE FOR RUSSIAN RUBLE AS CURRENCY OF LITHUANIA

The Fund finds, after consultation with the authorities of Lithuania, that the representative rate under Rule 0-2(b)(i) for the Russian ruble (as currency of Lithuania) against the U.S. dollar is the midpoint between buying and selling rates for the Russian ruble against the U.S. dollar in the interbank market, as ascertained by the Central Bank of Russia. (EBD/92/199, 9/4/92)

Decision No. 10130-(92/115)GS, adopted
September 10, 1992

6. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 92/26 and 92/27 are approved.

7. EXECUTIVE BOARD TRAVEL

Travel by an Assistant to Executive Director as set forth in EBAM/92/76 (9/8/92) is approved.

APPROVED: May 10, 1993

LEO VAN HOUTVEN
Secretary

